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Bank Defense of Negotiable Instrument Cases

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Impostors and Fictitious Payees

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IMPOSTORS AND FICTITIOUS PAYEES
By Professor James J. White

I. Basic Liabilities

A. Section 3-405 codifies and adds to section 9(3) of the Uniform Negotiable Instruments law. It provides for a series of cases in which an indorsement "in the name of a named payee" is effective even though that indorsement is made by some person other than the named payee. But for the application of 3-405, such an indorsement would be a forgery, would prevent subsequent takers from being holders or holders in due course and would cause each subsequent transferee to breach his warranty of good title. The consequence of 3-405's application is that the indorsement is good, subsequent parties have "good title," and so can enforce the instrument against the drawer notwithstanding the forgery. Section 3-405 reads in full as follows:

§ 3-405. Impostors; Signature in Name of Payee

(1) An indorsement by any person in the name of a named payee is effective if

- (a) an impostor by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee; or
- (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or
- (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.

(2) Nothing in this section shall affect the criminal or civil liability of the person so indorsing.

B. Subsection 1(a) deals with the standard case in which one person poses as another. A recent application of subsection a occurred when a crooked insurance agent posed as the insured and caused the insurance company to issue checks to him in the insured's name.

C. Subsection 1(b) deals with the case in which the drawer or a person with actual authority in the drawer's organization to draw, makes a check to one whom he intends to have no interest in the instrument. An example would be the case of a corporate treasurer who chose to draw a check to a fictitious payee and then to cash it.

D. Subsection 1(c) adds the prior law and is the most frequently invoked subsection in 3-405. It covers the so-called padded payroll or padded accounts payable situation in which the payroll clerk adds the name to the payroll, snatches the check on the way back through the payment process and cashes it.

E. The recent cases and the issues that they present.

1. Agency or not? According to the cases and the comments, subsection 1(a) does not encompass the case in which a party represents himself to be the agent of some third party and causes the check to be issued in the name of that third party. Comment 2 to 3-405 puts it as follows:

"Impostor" refers to impersonation and does not extend to a false representation that the party is the authorized agent of the payee. A maker or drawer who takes the precaution of making the instrument payable to the principal is entitled to have his indorsement.

For example, in *Fidelity and Deposit Co. of Maryland v. Chemical Bank New York Trust Co.*, 7 UCC Rep. Serv. 508 (N.Y. Civ. Ct. 1970) an accountant posing as the agent of two parties caused stock to be sold by a stock brokerage. The broker then sent his check in the name of the putative principals to the thief who forged their indorsements and cashed them. The court held that section 3-405 did not apply since the accountant had simply misrepresented his agency and had not posed as the named payees. Compare *Fidelity and Deposit Co. of Maryland v. Manufacturers Hanover Trust Co.*, 7 UCC Rep. Serv. 1142 (N.Y. Civ. Ct. 1970); in the Manufacturers case Loretta owned a savings account in a Savings and Loan Association. Either her former husband Wolfgang or her former husband's new wife appeared, presented a forged withdrawal order to the Savings and Loan Association and so caused a check to be drawn to Loretta's order. Either Wolfgang or his new wife then forged Loretta's indorsement on the check.

The drawer Savings and Loan argued that at least if Wolfgang was the one who had presented the withdrawal orders, there was no imposture, but only a misrepresentation of agency for Loretta to withdraw the money and thus that 3-405 would not apply. The court concluded that Wolfgang did not simply misrepresent his agency but that he in fact used the withdrawal orders to "pretend to be Loretta." The case seems questionable, most difficult to distinguish from the Chemical Bank case. See also *East Gadsden v. First City National Bank of Gadsden*, 13 UCC Rep. Serv. 275, 281 So.2d 431 (Ala. Ct. of App. 1973).

2. The existence of a real person or a real debt.

Under the pre-Code law it was sometimes argued that if the named payee was not wholly fictitious, but was in fact the name of a real person, the doctrine did not apply. The section rejects that argument and states in Comment 1 that "the existence or non-existence of the named payee is not decisive."

One cannot say the same for the existence or non-existence of a legitimate claim under the 1(c) cases. In *New Amsterdam Casualty Co. v. First Pennsylvania Bank and Trust Co. v. Neufeld*, 9 UCC Rep. Serv. 1169 (3d Cir. 1971) a crooked stockbroker periodically sold stocks from the accounts of his customers, caused checks made payable to their order to be drawn and then stole the checks and forged the indorsements. The drawee bank argued that 3-405(1)(c) applied on the theory that the stockbroker had supplied the drawer with the names of the payees and with the intent that they had no interest in the ultimate checks. The court accepted that argument. It rejected the argument that the customers were bona fide creditors and distinguished the Snug Harbor case discussed below on the ground that in Snug Harbor the payees were actual creditors. In *Snug Harbor Realty Co. v. First National Bank of Toms River, N.J.*, 253 A.2d 545, 6 UCC Rep. Serv. 689 (N.J. 1969) one Magee initialed valid invoices and forwarded them to Snug Harbor's bookkeeper. The bookkeeper verified the contractual obligations and prepared the checks. Magee stole the checks. The New Jersey court there rejected 3-405's application on the ground that "the payees were bona fide creditors of the company who had respectively submitted their invoices for work performed or materials furnished."

One rationale for the distinction between the two cases is that in Snug Harbor reasonably appropriate account-

ing, auditing and bookkeeping measures still might not have prevented the fraud, for a careful check would have disclosed that the accounts were in fact owed. In the broker's case an audit or cross check made at the time the checks were drawn would have disclosed that the customers had not ordered the securities sales and were not entitled to the money. It is not clear how one arrives at the Snug Harbor conclusion under the language of 3-405(1)(c). Perhaps he can say in that case the agent did not "supply" the name, rather that the name was in fact supplied by the creditor himself.

3. Supplied? Both Snug Harbor and Neufeld also present the question when has the employee "supplied . . . the name of the payee intending the latter to have no such interest"? Comment 4 to 3-405 points out that:

The provision applies only to the agent or employee of the drawer, and only to the agent or employee who supplies him with the name of the payee.

The section is not meant to cover the messenger who simply steals the check and forges an indorsement. Is there some line that distinguishes those who do supply names (payroll clerks) and those who do not (messenger)? In the Neufeld case the third circuit responded to that question with respect to the stockbroker who submitted fictitious sell orders as follows:

For the purpose of giving meaning to the word "supplied" in Section 3-405(1)(c), we can find no reasonable place to draw the line within the business enterprise of the drawer. Accordingly, in the context of the facts here, the only rational distinction lies between the bona fide and fraudulent transactions because it is only in the case of a bona fide transaction that anyone other than the faithless employee can be said to have supplied the name of the payee to the company. When Wexler, by submitting the fraudulent sell order to the trading room at Smith, initiated normal business practice to produce a check payable to a named payee, and Wexler intended the payee to have no interest in the proceeds of the check, he "supplied" Smith with the name of the payee thereby making his forged indorsement effective as between Smith and the drawee Bank.

II. Defenses and Miscellaneous Issues

A. Negligence. Since 3-405 is truly but a presumption of negligence on the part of the drawer, one can argue by analogy to 3-406 and 4-406 that if the depositary or drawee bank are themselves negligent, their negligence should bar them from use of 3-405; the signature should be regarded as ineffective, as a forgery. That would be the outcome under a routine application of the negligence principles of 3-406 where the customer's negligence does not operate against the bank if the bank itself fails to use "reasonable commercial standards." In *Prudential Insurance Co. of America v. Marine National Exchange Bank of Milwaukee*, 14 UCC Rep. Serv. 462 (E.D. Wis. 1974) Prudential issued a \$20,000 check payable to a policyholder. A Prudential employee had supplied the policy owner's name intending that she have no interest in the instrument. Williamson, the Prudential agent, forged the payee's name on the check and so transferred it to his bookie, Mr. Plotkin. The bank ultimately paid the \$20,000 check to the bookie. The bank then argued that the indorsement was effective because of 3-405(1)(c). Prudential responded that the cashing of a \$20,000 check for a bookie under such circumstances was not the observance of reasonable commercial standards and thus that the bank should be denied the use of 3-405 and be required to recredit its account. In rejecting Prudential's argument the court pointed out first that Prudential was not arguing bad faith or that the depositary bank was not a holder in due course. It observed that 3-405 "flatly states that . . . the loss should fall upon the employer of an unfaithful employee; no qualifications for the negligence of the payor bank is indicated."

In an analogous case on slightly different grounds the Tennessee Supreme Court came to a different conclusion, *McConnico v. Third National Bank of Nashville*, 499 S.W.2d 874, 13 UCC Rep. Serv. 641 (Tenn. 1973). In that case Mr. Hardison devised a variety of ways to get money out of his corporation and into his own hands. Ultimately the trustee in bankruptcy of the corporation challenged some of these transfers. One such transfer was a corporate check payable to the order of the "Clear Creek Coal Co." drawn by Hardison. Hardison forged the indorsement of the coal company and deposited the check in his own account. The bank's teller's manual specified that checks payable to corporations could not be cashed and had to be deposited to the account of the payee. The court found that the defendant bank received notice from the face of the instrument that the transactions "were highly irregular." The court held that such notice precluded the bank from becoming a holder in due course and found them to be liable on the check despite 3-405. The court fails to note that section 3-405 does not speak of holders in due course and says

simply that indorsements which comply with 3-405 are "effective." Presumably such indorsements would be as effective for non-holders in due course as for holders in due course. Therefore it is unclear why notice and non-holder-in-due-course status produce a contrary result in the Tennessee case unless that court is really concluding that one who is negligent is not entitled to the protection of 3-405.

B. Note that if the forger is not careful to sign the exact name of the fictitious payee, section 3-405 may not apply. See *Travco Corp. v. Citizens Federal Savings & Loan Assn. of Port Huron*, 42 Mich. App. 291, 201 N.W.2d 675, 11 UCC Rep. Serv. 779 (Mich. Ct. of App. 1972). That literal reading of the indorsement rules illustrates the same thing as the Tennessee case, namely, courts will grasp for a way to deprive the depository or payor banks of the protection of 3-405 in circumstances in which the courts regard the banks as negligent.

C. Dual forgery. In *Aetna Life & Casualty Co. v. Hampton State Bank*, 497 S.W.2d 80, 13 UCC Rep. Serv. 876 (Tex. Ct. of Civ. App. 1973), a thief forged the signature of Mr. F.J. Spillman, president of Pizza Inn, Inc. and made the check payable to a fictitious organization "Pizza Inn, Inc. No. 32." The thief then opened an account at Hampton State Bank in the name of Pizza Inn, Inc. No. 32, deposited the \$4,000 check and ultimately withdrew most of that sum. Northwest National Bank made final payment on the check. Subsequently Hampton asked Northwest to return the check and made a claim against its bonding company. The appellate court held that the bonding company did not owe Hampton anything because the underlying transaction had not caused Hampton any loss "through forgery." The court found that the indorsement was effective because the thief signed "as or on behalf of" the drawer (3-405). Thus the warranty of good title was not breached and the loss should have rested on the payor under the doctrine of Price v. Neal. (Note the court might have reached the same conclusion by concluding, under 3-401(2), that the indorsement was effective under an assumed name selected by the thief.)